Internal Revenue Service
memorandum

date: MAR 27 1991

to: District Director, Richmond District
Attn: Gabrielle Hughes, IE

from: Special Counsel (International)

subject: Application of the 5 Percent Reduced Rate of Tax on Dividends Under the U.S.-N.A. Tax Treaty

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This is in response to your inquiry regarding the application of the 5 percent reduced rate under the U.S.-N.A. tax treaty with respect to dividends paid by a U.S. corporation to its Netherlands Antilles parent in the following circumstances.

In the early [redacted], a group of Middle Eastern investors formed a corporation in the Netherlands Antilles ("[redacted]") for the purpose of acquiring [redacted]% of the stock of a U.S. corporation ("[redacted]") engaged in active U.S. business operations. [redacted] acquired an additional [redacted]% interest two years later and total ownership the next year. We will assume, for purposes of this memorandum, that there was no plan at the outset to increase ownership beyond the initial stock acquisition. Shortly after [redacted] acquired total ownership of the taxpayer's stock, [redacted] paid dividends to [redacted] in the total amount of $[redacted]. The payments were made directly by [redacted] to third parties in satisfaction of [redacted]s liabilities to those persons. [redacted] does not dispute that those payments are properly treated as constructive dividends to [redacted].

[redacted] withheld a 5% tax on the dividends under Article VII of the U.S.-N.A. tax treaty. It was provided no Form 1001 and neither the taxpayer nor [redacted] applied for IRS approval of the 5% rate.

After the U.S.-N.A. tax treaty terminated effective in 1988, [redacted] stock was transferred by [redacted] to a newly organized Dutch corporation.

ISSUE

Under Article VII of the U.S.-N.A. tax treaty, a reduced 5% rate is available for certain dividends provided the relationship of the U.S. subsidiary and its Netherlands Antilles parent was not arranged or maintained primarily with the intention of securing the reduced rate. The issue is whether [redacted] is entitled to the reduced 5% rate with respect to constructive dividends from [redacted] or whether the reduction of the U.S. tax rate under Article VII of the U.S.-N.A. tax treaty should be limited to the 15% rate.

ANSWER

The short answer, based on the foregoing facts and the authorities discussed below, is that, even if the [redacted] relationship was not initially established primarily to secure the 5% rate under the treaty, the taxpayer has not established that it satisfies the "not primarily maintained" test. The Service's position is that, in order to prove its case, the taxpayer must show (1) that there were "business exigencies" for establishing the corporation in the N.A., and (2) that those business exigencies continued to exist at the time the dividends were paid.

DISCUSSION

Under section 881(a)(1) of the Code, a foreign corporation is liable for a 30% tax on dividends received from U.S. source. Under section 1442(a) of the Code, [redacted] was required to withhold the tax owed under section 881 with respect to the dividend paid to [redacted]. As a withholding agent, [redacted] is generally liable for the tax under section 1461 if it failed to withhold the correct amount of tax.

Article VII(1) of the U.S.-N.A. tax treaty reduces this rate to 15%. Under the same Article, the rate is further reduced to 5% if three conditions are satisfied: (i) the N.A. parent owns at least 95% of the voting power of the U.S. subsidiary; (ii) the U.S. subsidiary's gross income from certain interest and dividends does not exceed 25%; and (iii) the relationship of the U.S. subsidiary and its Netherlands Antilles parent was not arranged or maintained primarily with the intention of securing the 5% reduced rate. Also, benefits under the U.S.-N.A. tax treaty may be conditioned upon meeting certain other requirements set forth in Article I(1) or I(2) of the 1963 Supplemental Protocol to the treaty. In this particular case, the dividend income would satisfy the Protocol requirement that the payor of the dividends not be an investment company.

The legal issue in this case -- whether the IRS can collect an additional 10% tax from the taxpayer as a withholding agent -- must be analyzed in two steps: (i) first we must determine whether the rate of tax applicable to dividends received from the taxpayer was 5% or 15%; and (ii) if we determine that the applicable rate was 15%, we must then determine whether the taxpayer is liable, as a withholding agent, for the shortfall in the amount of additional U.S. tax owed by [redacted].

(a) Was [redacted] entitled to the reduced 5% rate under the U.S.-N.A. tax treaty?

In this case, the only relevant issue with respect to this question is whether the relationship of the U.S. subsidiary and [redacted] was "arranged or maintained primarily" with the intention of securing the 5% reduced rate.

In Rev. Rul. 79-65, 1979-1 C.B. 458 the Service denied the 5% reduced rate to a Netherlands Antilles company that did not supply information demonstrating (1) that business exigencies dictated the organization of the company in the Netherlands Antilles, and (2) that any dividends paid by the Netherlands Antilles company to its shareholder was not paid merely as a result of a dividend being received from the U.S. subsidiary.

At a meeting with the taxpayer's representative and in prior submissions to you, the taxpayer argued that it is entitled to the reduced 5% rate because:

1. Taxpayers must only establish that there were good business reasons for incorporating the company outside the country of residence of the shareholders. This test is met in this case since the war situation in Lebanon made it impractical to incorporate in Lebanon.

2. The investors explored other jurisdictions and selected the N.A. for good business reasons, such as proximity to the U.S., ease of access into various worldwide markets without bias, good communications, stable banking facilities, ease of incorporation.

3. The investors could have avoided the issue by structuring their investment differently, e.g., leveraging the investment to create interest deductions and eliminate E&Ps.

4. Similarly, the U.S. subsidiary could have made a distribution in an earlier year when there were no E&Ps.

5. The dividend distribution was used to pay the sellers of the U.S. subsidiary stock. The shareholders never had the benefit from those funds. Thus, [redacted] was not used a conduit.

6. [redacted] was not established to take advantage of the 5% reduced rate since that rate was not available when [redacted] was organized. Further, when the 5% rate became available, [redacted] did not remain in the N.A. primarily to benefit from that rate. It remained in the N.A. primarily because it had no reason to move anywhere else. Requiring taxpayers to prove the negative (i.e., show why [redacted] did not move out) would be an unfair burden. It should be sufficient to show that there were business reasons for being there in the first place and that there are no obvious business detriments resulting from remaining in the jurisdiction. Also, the fact that there would have been costs associated with moving [redacted] is a factor to take into account.

Assuming that [redacted]'s shareholders did not anticipate increasing [redacted]'s initial [redacted]% ownership to [redacted]%, then we must concede that [redacted]'s relationship with [redacted] was not arranged "primarily with the intention of securing [the] reduced rate" since the 5% reduced rate was not available when [redacted] was organized and [redacted] did not anticipate then that it might be in a position in the future to qualify for the 5% rate.

Thus, the issue in this case is whether, after ownership increased to [redacted]%, the relationship was maintained primarily with the intention to secure the 5% reduced rate.

As we discussed at the meeting, the Service's position is that, in order for the taxpayer to establish that [redacted] was not maintained primarily to benefit from the reduced rate, the taxpayer must show (1) that there were "business exigencies" for establishing the corporation in the N.A., and (2) that those business exigencies continued to exist at the time the dividends were paid. We believe, however, that even if the taxpayer could not satisfy their burden with respect to (1) or (2), above, our case would be fairly weak if the taxpayer established that there would have been substantial costs or other detriments associated with restructuring after ownership increased to [redacted]%.

The facts presented at the meeting and reflected in this memorandum, do not, in our view, prove the "business exigencies" for incorporating in the NA. First we note that, during the same time period, the investors operated other businesses in the Middle Eastern region through various Lebanese companies. Thus, it seems that incorporating in Lebanon would not have been that impractical. Also, even if we accept that the investors had good reasons for incorporating or maintaining a corporate structure outside Lebanon, our position, based upon Rev. Rul. 79-65, is that the taxpayer must demonstrate the "business exigencies" that justify incorporating or remaining in the N.A. rather than anywhere else, and not just compare the N.A. and Lebanon. In other words, the "business exigencies" language in Rev. Rul. 79-65 requires taxpayers to show some special business advantage resulting from incorporating or remaining in the N.A. rather than anywhere else. Thus, if other locations offer the same type of advantages cited by the taxpayer, then it has not met its burden under the treaty.

The fact that the investment could have been structured or financed differently, or that the distributions could have been timed differently, demonstrates nothing because those alternatives assume different business arrangements and the taxpayer has not shown that those alternatives were available or practical. Also, the test must be applied in view of what was actually done rather than in view of what could have been done.

The taxpayer has presented no evidence regarding the costs or detriments that would have been associated with restructuring outside of the N.A.. In fact, the fact that [redacted] was restructured as a Dutch holding company following the termination of the U.S.-Netherlands Antilles treaty proves (1) that restructuring was feasible, and (2) that the primary, if not the only, reason for establishing [redacted] in the N.A. was to secure tax treaty benefits. Then, it follows that, when [redacted] qualified for the 5% rate, the primary reason for maintaining the relationship was to secure the reduced rate.

In order for the taxpayer to overcome this presumption, it would have to show why the N.A. was the best place to establish [redacted] (other than the tax reason). It is doubtful that this can be done.

(b) <u>Is the taxpayer liable for the shortfall as a withholding agent</u>?

Under section 1442, a U.S. corporation paying U.S. source dividends to a foreign person must withhold the tax imposed under section 881(a)(1). Under section 1461, a withholding agent is made liable for the tax. Thus, the IRS may collect from the withholding agent any shortfall in the amount of tax owed under section 881(a), unless such agent can establish (i) that the tax was otherwise paid by the foreign person or (ii) that the agent complied with the withholding tax procedures that may excuse the failure to withhold. Those procedures, including procedures for withholding at a reduced rate of tax pursuant to a treaty provision, are set forth in the regulations under section 1441 and 1442, and, in the case of the U.S.-N.A. tax treaty, in regulations under the treaty, as supplemented by Rev. Proc. 79-40, 1979-2 C.B. 504.

Treas. Reg § 1.1441-6(a) provides that, with respect to dividends, no form 1001 is required. The withholding agent "shall determine the applicable rate pursuant to the appropriate tax treaty and the regulations thereunder." Regulations under the U.S.-N.A. tax treaty provide that a domestic corporation claiming the application of the reduced 5% rate must file a notification with the Service "as soon as practicable" and the Service will then issue a determination to the corporation as to the applicability of the reduced rate. Treas. Reg. § 505.302(c). Rev. Proc. 79-40 amends those procedures and requires taxpayers to file a ruling request with the Service prior to the payment of the dividend. It also requires the withholding agent to obtain a so-called VS-3 or VS-4 certificate from the payee in cases in which qualification for the lower rates depend upon meeting the requirements of Article I(1) or I(2)(b) of the 1963 Protocol. No such certificates were required in this case.

Even if we assume that the pre-filing requirement imposed under the revenue procedure is invalid[1], [redacted] has not complied with the filing requirements in Treas. Reg. § 505.302(c)(2), and, therefore, remains liable for the tax as a withholding agent if we determine that the tax is, in substance, due from [redacted].

CHRISTINE HALPHEN

cc: Marion Morton, District Counsel MA:RCH
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[1] In Casanova v. Commissioner, 87 T.C. 214 (1986), the Tax Court suggested that the revenue procedure is invalid to the extent it imposes requirements that are substantially more burdensome than those called for under the regulations.